WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Micro Cap Growth—U.S. Strategy

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Because Difficult Business Conditions May Have Become the “New Normal,” We Want Our Companies To Be Positioned Well With Respect to Balance Sheets And Cash Flows

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OVERVIEW

The stocks of U.S. micro-cap growth companies moved higher during the fourth quarter of 2022, carried by optimism about the future of inflation and interest rates. The benchmark Russell Microcap® Index gained 4.72%. The Wasatch Micro Cap Growth—U.S. strategy declined during the quarter and underperformed its benchmark.

From a sector perspective, the strategy’s primary sources of weakness relative to the benchmark were disappointing returns in industrials, financials and consumer discretionary. An overweight position and underperformance in information technology (IT) were also detrimental. At the other end of the spectrum, relative strength came from robust returns in consumer staples.

While there’s no doubt that business conditions have improved since the height of the Covid-19 pandemic, it seems likely that challenges will continue to crop up. As a result, we’re not counting on macro improvements to provide a tailwind for our investments. Instead, we’re focused on companies that have excellent management teams and that can grow in a variety of economic environments.

We're pleased to report that our travel schedule to visit companies has ramped up. Most recently, we went to Texas for meetings with the management teams of TaskUS, Inc. (TASK) and CS Disco, Inc. (LAW). TaskUS is a newer holding for us. The company is a leader in business-process outsourcing, including customer service and content monitoring. The company's strong execution has earned it a reputation as the go-to partner for high-growth technology businesses. The bear market and some minor company-specific issues pushed down the market capitalization of TaskUS into the micro-cap range, enabling us to add this high-quality company to the strategy.

CS Disco has faced significant challenges recently. This legal-technology company provides a cloud-based platform of artificial-intelligence solutions for e-discovery, legal-document review and case management. Because CS Disco has a limited history as a publicly traded company and is aggressively spending cash to fund its growth, skeptical investors drove the stock price down. Moreover, the legal-document review segment of the company's business depends on incremental usage that's extremely volatile because the segment is very early in the adoption cycle. Based on our visit and our discussions with customers, we're cautiously optimistic that adoption will ramp up, volatility will decline and revenue per client will grow. In addition, CS Disco's large cash position could help the company to realize the market opportunity for its cloud-based platform, which we believe has the potential to make the legal industry much more efficient.

DETAILS OF THE QUARTER

Grid Dynamics Holdings, Inc. (GDYN) was the greatest detractor from strategy performance during the fourth quarter. The company provides *Fortune 1000* businesses and other firms with a range of technology services—including consulting, software design, internet business development, cloud computing and legacy replatforming—and thus had benefited from the secular move toward digitalization. However, Grid has a significant number of employees in Ukraine. After a period of relative calm in major Ukrainian cities, recent escalating Russian attacks on power plants and other vital infrastructure have once again raised concerns. But we've been impressed by the ability of Grid's management to navigate these challenges over a difficult year, and we expect management will continue to find ways to thrive in the digitalization space, which we think will be resilient in the face of a potential recession. As such, we added to our position when the recent retracement in the stock price created an attractive buying opportunity.

Another significant detractor was Inotiv, Inc. (NOTV). The company, a contract-research organization that serves the biotechnology industry, is a major buyer of non-human primates (NHPs) for medical testing. NHPs are vital for medical advances and are often necessary to gain regulatory approvals for drugs and other treatments. A mid-quarter announcement that Inotiv's main provider of NHPs was associated with an indictment related to animal smuggling raised concerns that the company might have trouble securing a sufficient allotment in the future. Looking ahead, the fate of NHP supplies is uncertain. But given the overall supply shortage due to Covid-19 even before the indictment, it's possible that the interested parties—including regulators—will reach a rapid resolution with minimal disruptions. Nevertheless, we'll closely monitor developments and adjust our position in Inotiv accordingly.

Simulations Plus, Inc. (SLP) was also a detractor. The company produces drug discovery and development software designed to help pharmaceutical firms shorten the time required to bring drugs to market. As life sciences businesses continue to adopt modeling and simulation, we believe Simulations Plus is well-positioned for growth in a high-margin industry. The company's scientific consulting services are also experiencing strong demand, and its sales team has demonstrated success in cross-selling to existing customers. The stock's weakness during the quarter was the result of lumpy financial results caused by the timing of contract renewals, which should gradually even out as Simulations Plus grows.

Agilysys, Inc. (AGYS) was the top contributor to strategy performance during the fourth quarter. The company develops application software for point-of-sale, property-management, inventory and procurement applications. Agilysys specializes in the hospitality and retail industries world-wide, and its solutions can be implemented on wireless and mobile devices. The company recently modernized its software, which has proved fortuitous as post-pandemic consumer and business travel has accelerated. On December 15, Agilysys announced an agreement to deploy its cloud-based property-management system software across Marriott's luxury, premium and select service hotels in the United States and Canada. Beyond the incremental earnings and cash flows related to Marriott, the agreement should help Agilysys win new customers on an ongoing basis.

Another meaningful contributor was UFP Technologies, Inc. (UFPT), which designs and manufactures a range of high-performance cushion packaging and specialty foam and plastic products for industrial and consumer markets. In the past, UFP also made precision-molded fiber packaging primarily from recycled paper. But the company recently divested from that business segment due to margins being lower than those in other business segments. Conversely, UFP has made acquisitions of firms serving the higher-margin medical industry. The company's recent revenues and earnings were strong, which boosted the stock price. Moreover, with elective medical procedures ramping up after declines amid the pandemic, we expect UFP will start to experience faster growth and even better margins.

Impinj, Inc. (PI) was also a contributor. The company, a pioneer in helping develop the Internet of Things, provides an infrastructure by which everyday things such as car parts and even shipment data communicate over the internet. Impinj offers a wireless inventory-management and tracking platform for customers in retail, manufacturing, health care and other areas. Tiny radio-frequency identification (RFID) chips are used to connect, count and track individual items. Because Impinj is heavily reliant on integrated circuits, which were in short supply during the post-pandemic rebound, today's slowing economy helps reduce this supply-and-demand imbalance, benefiting the company's profitability. The stock soared when Impinj's third-quarter earnings report and management's forward guidance were well-received by investors. Given the magnitude of the move in the stock, we sold some of our shares but maintained a healthy position.

OUTLOOK

As described above, rather than counting on macro improvements of business conditions, we're focused on companies that we believe can effectively navigate ongoing challenges. In practice, this means that instead of being told conditions are difficult, we want to hear from management teams that they have a robust operating model and are positioning themselves for success. After all, difficult business conditions may be the "new normal" for many companies.

We also want to make sure the strategy is generally well-positioned with respect to our companies' balance sheets and cash flows. For holdings that are spending cash at higher levels, we analyze their balance sheets to ensure enough cash is on hand to meet burn rates and alleviate liquidity concerns.

In terms of recent additions to the strategy, we're finding some attractive valuations in restaurants and other consumer-related names. With commodity prices off their highs and wages moderating, input costs have come down and margins have improved for many restaurants and consumer-products companies. Moreover, these companies often have deeply discounted stock prices even though their businesses show significant possibility for growth.

One restaurant company we bought during the quarter was the Tex-Mex chain Chuy's Holdings, Inc. (CHUY). We had owned Chuy's in the past, so we're very familiar with the company and its loyal customer base. Today, we find the stock's valuation to be attractive based on the company's healthy balance sheet, strong free cash flows, and ability to add locations and improve sales per location over the long term. Management also did a great job navigating the Covid-19 pandemic, and the result is a business that uses labor more efficiently and manages costs better than it did before the pandemic. Going forward, lower prices for food and other inputs should also provide a tailwind to company margins.

Among consumer-products companies, we bought another name that we had held in the past—Purple Innovation, Inc. (PRPL). The company produces and markets mattresses, pillows, sheets, other bedding products and cushions. Purple's injection-molded GelFlex Grid is made from a proprietary polymer and provides cushioned comfort while maintaining support. After experiencing some business-development challenges a few years ago, we think Purple is now well-positioned to take market share in a growing industry. What adds to our confidence is that the company's new CEO is experienced in building excellent management teams, reducing costs and partnering with top-notch retailers.

We've also invested in companies with countercyclical growth potential. For example, lending company EZCORP, Inc. (EZPW) serves less-affluent individuals who may struggle amid high inflation or recession. The company owns and operates pawn stores that generate very strong cash flows. Customers can buy merchandise at discounted prices, sell unneeded belongings or receive loans based on items of value.

Regarding long-term trends that we'd like the strategy to benefit from, it's clear that U.S. infrastructure needs to be upgraded nationwide and that government spending has been prioritized accordingly. As a result, we've invested in companies that we think are recession-resistant such as Construction Partners, Inc. (ROAD), which specializes in projects such as highways, bridges and airports. Moreover, any commodity price inflation that's been incorporated in the company's contracts may help improve margins going forward.

Finally, while we're aware that many IT companies are facing customers with tight budgets, the good news is that the sector has received an important message: The mantra of "growth at all costs" is no longer acceptable, and profitability must now be a high priority. In this new environment, we think we'll be in a better position to find more IT companies—like the aforementioned Agilysys—with the potential to generate strong cash flows over the long term.

Thank you for the opportunity to manage your assets.

Sincerely,

Ken Korngiebel and Natalie Pesqué

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